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THE CALIFORNIA ECONOMIC OUTLOOK

FALL 1984

SECURITY
PACIFIC
CORPORATION

CONTENTS

2 The U.S. Outlook
This section covers the short-term view of the United States economy, with discussions on monetary and fiscal policy, consumer and business spending, inflation, and international developments.

7 California Economic Outlook
A detailed look at key economic indicators for California: employment, personal income, consumer price trends, and consumer spending are analyzed.

14 California Industry Trends
In this section the near-term future of several key components of the California economy are presented, including: aerospace/high-technology, construction, tourism, international trade, and agriculture.

24 California's Regions
The vastness and diversity of the state are underscored in this section. As the outlook for each of the state's three major regions unfolds, the central elements of each region are defined and analyzed.

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HIGHLIGHTS

The United States economy through 1987 will be characterized by a low rate of inflation, accommodative monetary policy, a relatively weak dollar exchange rate, and modest economic growth. Moreover, the issue of the day will be tax reform; businesses and individuals alike will be scrambling to unravel the new tax package in an effort to gain maximum advantage under the new tax rules.

Like the nation, the California economy will continue to experience moderately expanding economic activity, but will have to endure ongoing difficulties in several key sectors – notably, agriculture, energy, and manufacturing. The consumer will continue to be king, fostering a bright outlook in residential construction, retail sales, and service industries. However, there will be insufficient buoyancy to generate major business investment, particularly in new commercial and industrial projects.

Across the state, whether in the Southern, Central, or Northern region, the story will be much the same, continued but undramatic growth. On the brighter side, this expansion has been a long one, more than five years by the end of 1987, and there is yet little to suggest that a recession is imminent over the next 18 months.

THE U.S. OUTLOOK

THE U.S. OUTLOOK: OVERVIEW

Growth in U.S. aggregate economic activity slowed over the past two years, with real GNP advancing 2.7 percent in 1985 and 2.3 percent in the first half of 1986. Although this performance was weak relative to 1983 and 1984, such a slowdown in economic growth is not unusual at this stage of an expansion.

The rapid growth of real output during the first two years of the recovery produced certain imbalances in the economy which contributed to the moderate 1985 and 1986 performance. These imbalances included heavy inventory building, dramatic increases in the foreign exchange value of the dollar and the trade deficit, and large increases in debt-financed consumer durable purchases. These factors, however, are expected to improve over the next year. The recent drop in the foreign exchange value of the dollar will make U.S. goods more competitive in both domestic and foreign markets and should result in a declining U.S. trade deficit. Similarly, consumers' balance sheets should benefit from lower real interest rates, healthy income growth, and recent advances in stock prices.

At the ripe old age of 46 months, the current expansion is one of the longest in U.S. history. Given the advanced stage of the present cycle, several economists have suggested that the economy is overdue for a recession. The business cycle is not a self-generating mechanism, however. Instead, it reflects the accumulated effects of changes in fundamental economic forces. The age of the expansion, by itself, does not signal a turning point in the economy. As long as positive economic fundamentals are in place, there is little reason to expect a recession.

Record declines in interest rates, oil prices, and the value of the dollar will provide the fuel necessary to keep the economy on a moderate growth path through 1987. Lower interest rates and energy prices will lead to higher consumer spending, while a lower dollar will make U.S. goods more competitive in both domestic and foreign markets, as well as help reduce the U.S. trade deficit. As a result, real GNP is expected to register an increase of 2.6 percent in 1986, and 3.0 percent in 1987.

Economic Outlook
Selected Economic Indicators

	1985	1986f	1987f
Housing Starts*	1.74	1.90	1.79
Automobile Sales*	11.0	10.9	11.0
Personal Income	3514.5	3506.2	3711.2
% Change	6.6	5.8	5.8
Disposable Personal Income	2828.0	2996.8	3165.6
% Change	5.9	5.9	5.6
Saving Rate (%)	5.1	4.9	4.5
Industrial Production (1977 = 100)	124.5	125.2	128.1
% Change	2.3	0.6	2.2
Unemployment Rate (%)	7.2	7.0	6.7
Producer Price Index (1967 = 100) Finished Goods	293.8	290.0	297.6
% Change	0.9	–1.3	2.6
Consumer Price Index (1967 = 100)	322.1	328.2	338.1
% Change	3.5	1.9	3.0

*Millions f = forecast

MONETARY POLICY

Interest rates have fallen sharply since the beginning of 1986. The bond markets had their biggest rally in history in the February-April period. The Federal Reserve cut their official discount rate four times before August of this year for a total of two percentage points. The discount rate, at 5.5 percent, has not been this low since 1977.

Much of the drop is linked to a very accommodative credit policy on the part of the Federal Reserve. In an effort to help alleviate the trade deficit and to rejuvenate growth, Chairman Volcker has helped to arrange two coordinated interest rate cuts with our major trading partners, with one unilateral cut coming from the U.S. designed to pressure our allies into further rate cuts. The intention is not only to get our economy back on its feet, but to spur growth in our major trading partners so that their imports will rise and our exports will become more competitive. Such actions have yet to show any success.

The Fed continues to grapple with the controversy over the extremely rapid growth in the narrow measure of the money supply known as M-1 (which includes currency, demand deposits, and some interest-bearing accounts). Growth in this measure has been as high as 25 percent in some months and is of great concern to those who believe that strong money growth will eventually bring high levels of inflation. Other analysts contend that M-1 is not as historically significant since the deregulation of deposit rates. The sharp drop in interest rates in recent

years and months has lowered the cost of holding funds in the form of non-earning M-1, giving more corporations and individuals the incentive to park funds in M-1 components, waiting for higher rates of return.

The composition of the Federal Reserve Board has changed in 1986 to reflect more and more the increasing influence of the Reagan Administration. Charles Partee, Lyle Gramley, and Vice-Chairman Preston Martin have all left the Board, and have been replaced by Manuel Johnson, Wayne Angell, and Robert Heller. Add to their ranks Martha Seger and there is a clear-cut majority on the Board towards an easier monetary policy stance. The weak economy and near elimination of inflation have bolstered their confidence that an easier credit policy is the answer. It is very likely that further interest rate declines will occur in the near-term, to be followed next year by a gradual rise (of 1 to 1.5 percentage points) in interest rates.

GOVERNMENT SPENDING AND FISCAL POLICY

The drive for tax reform received a shot in the arm last month with the approval by House-Senate conferees of a substantial revision of the nation's tax code. The bill, which is similar to the Senate Finance plan, lowers tax rates for individuals and corporations.

With the backing of the White House and broad support from business groups, the plan is expected to be passed by the full Senate and House, and signed by the President.

The new plan differs significantly from the present tax code. There are two marginal rates for individuals, 15 percent for couples earning up to $29,750, and 28 percent thereafter, compared to 14 rates in the current code which range from 11 percent to 50 percent. Similarly, the maximum corporate tax rate would be reduced from 46 percent to 34 percent to remain revenue neutral, the plan either repeals or reduces the attractiveness of several popular tax shelters, including IRA deductions, the investment tax credit, and capital gains exclusions.

Over the next five years, the net effect of the bill would be to redistribute $120 billion from corporations to individuals by boosting total corporate taxes nearly 22 percent. Individuals, on average, would receive a tax cut of about 5.0 percent. This increase in corporate taxes relative to total federal taxes would return it slightly above the level that prevailed in the late 1970s.

Some uncertainty surrounds the federal budget outlook. A new tax law is pending, and an important part of the Gramm-Rudman Deficit Reduction Act has been ruled unconstitutional by the Supreme Court. Nevertheless, the deficit is expected to decline, at least for fiscal year 1987, as a Congress which passed Gramm-Rudman would be hard-pressed not to pass a resolution calling for a reduced deficit before the upcoming election.

The deficit for fiscal 1986, which is anticipated to be between $210 and $220 billion, will exceed our expectations (of $180 billion) earlier this year. For fiscal 1987, the government will likely start with a budget close to the Gramm-Rudman target of $144 billion but will probably end the year with a deficit of $160 to $180 billion.

Although deficits have been helped by lower interest rates, the discrepancy between the original government estimates and the final numbers arose because of slower-than-expected growth, higher-than-expected subsidies to agriculture and larger expenditures on defense.

THE OUTLOOK FOR CONSUMER SPENDING

Consumer spending was a primary source of economic strength in 1985, rising 3.6 percent relative to a 2.7 percent increase in real GNP. Strength in consumer spending during the current expansion has been fueled by moderate increases in real incomes and household net worth, lower inflation and interest rates, and an increase in consumer debt.

Some analysts have expressed concern that recent trends of debt accumulation and low personal saving will soon lead to a sharp reduction in consumer spending, and an economic downturn. The ratio of consumer installment debt to after-tax income, which is often cited as a measure of households' capacity to carry additional debt, increased from a recession low of 14 percent at the end of 1982 to a record high of 19 percent in June 1986. The continued low personal saving rate, at 5 percent of disposable income in the first quarter (versus a more normal 6 percent) is an additional argument often raised to support a need for retrenchment of the household sector. A close look at the data, however, indicates that the doomsayers are premature in their conclusions.

In addition to the increase in debt related to the cyclical expansion in consumer purchases, there is a longer-term upward trend in the debt/income ratio. The Federal Reserve Bank of Kansas City, in a 1985 study, noted several factors underlying this trend, including the use of credit cards as a substitute for checks; the lengthening of consumer loan maturities (raising the amount of outstanding debt for a given monthly payment); and a population shift toward a higher proportion of households in the heavy-borrowing ages of 25 through 44. In total, these factors have likely added several percentage points to the debt/income ratio during the last decade.

The personal saving rate, which has been the focus of much recent attention, is defined as the percentage of income left over (or "saved") after total consumer spending is subtracted from after-tax income. This measure fell during the third quarter of 1985, leaving a sharply reduced amount for saving. The decline was largely a result of weak farm earnings, lower interest income, and slow growth in manufacturing wages over that period. The other main factor in the saving decline was the continued expansion in consumer spending, partly in response to renewed financing incentives for autos.

Additionally, more comprehensive measures of national saving have not shown similar recent declines. For example, net private saving, which includes the saving of businesses (undistributed corporate profits net of depreciation) in addition to that of households, was at a higher level (6.4 percent of GNP) in 1985 than in 1982 (5.5 percent). Since it is the household sector that owns all businesses, business saving ultimately accrues to the household sector.

Security Pacific's forecast calls for a continuation of moderate increases in consumption through 1987. Low energy prices, interest rates, and inflation, combined with moderate income growth will promote gains in nondurables and services, while the expected continuation of subsidized financing programs by major auto makers should maintain auto sales at a healthy annual pace of 11 million units through year-end.

OUTLOOK FOR INVESTMENT

Strong gains in business fixed investment have been an important component of the current economic expansion. After declining 6 percent between 1979 and 1982, fixed investment rose 17 percent in 1984, nearly 8 percent in 1985 and an estimated 1.1 percent in 1986. This performance is particularly noteworthy since it took place during a period of historically high interest rates.

The outlook for investment, however, is clouded by potential changes in the tax code. Under the proposed tax plan, developed by the Senate and the House, the share of GNP devoted to business fixed investment would decline, and the composition of investment also would change significantly.

The repeal of the investment tax credit would depress spending for producers of durable equipment, but more generous depreciation schedules provided under the Senate plan and the reduction of the top corporate tax rate would partially offset this decline.

Real estate investment would be permitted far less generous depreciation schedules than under current law. Under the new plan, the current 19-year accelerated depreciation schedule would be stretched out to 30

years, with no provision for accelerated write-offs. Moreover, investors would be prohibited from using losses sustained in limited partnerships, in which the investor does not participate materially to offset income from other sources.

The net effect of these changes would be a lower, but more efficient level of investment. Under both the House and Senate tax plans, investment would be motivated by economic fundamentals, not tax considerations.

We expect investment in nonresidential structures to decline through 1987 reflecting less favorable tax treatment of this sector and historically high office vacancy rates in most urban areas. Expenditures on producers' durable equipment are expected to increase moderately, reflecting stable real interest rates and economic growth, and a continuation of low oil prices.

OUTLOOK FOR INFLATION

Deflation was the case in the U.S. for most of the first half of 1986 as plummeting oil prices resulted in significant declines in both the consumer and producer price indices. Between December, 1985 and March, 1986 the CPI fell at an annual rate of 2 percent, its greatest decline for any three month period since 1954. Meanwhile, producer prices collapsed at a record 12.4 percent annual rate. In June, while producer prices still declined 0.1 percent, consumer prices reversed course with a robust 0.5 percent rise, its largest since November 1985. This was due primarily to a temporary jump in oil prices, and increased medical, transportation, and housing costs.

One factor that is often an important determinant of the rate of inflation is the foreign exchange value of the dollar. Since its peak in early 1985, the dollar, when measured against a trade-weighted basket of currencies, has fallen nearly 30 percent. One of the economic effects of such a currency depreciation is higher prices of imported goods and services. Moreover, this effect will be magnified by the present high level of imported goods. In the second quarter of 1986, U.S. imports stood at a record $518.3 billion. Another possible source for higher inflation is an increase in food costs due to the drought in the Southeast. However, because of excess supplies, the impact of the drought on national food prices is expected to be modest.

Although these forces could combine with other prices which are on the rise (medical care and housing, for example) to refuel the inflation fire, the continuation of weak oil prices should balance these effects and keep inflation in check through 1987. As a positive "supply shock," cheaper energy boosts productivity and increases potential economic output. Oil costs also have a direct effect on inflation since they account for approximately 10% of the consumer price index.

The Security Pacific forecast calls for moderate inflation through 1987. For 1986 we expect the consumer price index to rise 1.9 percent followed by a 3.0 percent increase in 1987. The producer price index is expected to decline 1.3 percent in 1986 and rise by 2.6 percent in 1987.

Outlook For Real Growth

Percent Change

	1985a	1986f	1987f
Gross National Product	2.7	2.6	3.0
Personal Consumption			
Expenditures	3.5	3.9	3.2
Durables	7.8	4.0	4.4
Motor Vehicles & Parts	7.7	–0.2	4.1
Other Durables	7.9	7.5	4.7
Nondurables	1.6	4.3	2.9
Services	3.7	3.6	3.1
Gross Private Domestic			
Investment	–0.6	3.0	–0.4
Fixed Investment	7.8	1.1	0.3
Nonresidential	9.3	–1.6	–0.4
Producers' Durable Equipment	10.1	3.1	2.8
Structures	7.7	–12.2	–8.1
Residential	3.9	8.2	2.2
Change in Inventories ($)	9.0	21.5	20.6
Government Purchases	6.8	2.2	1.4
Federal	10.9	.6	0.9
National Defense	7.4	4.2	1.1
Nondefense	21.5	–9.2	0.1
State & Local	3.7	3.6	1.9
Net Exports ($)	–108.2	–140.7	–120.5
Exports	–2.0	2.2	7.4
Imports	3.8	8.6	1.4
Final Sales	4.2	2.3	3.1

a = actual f = forecast

INTERNATIONAL DEVELOPMENTS

The external sector of the U.S. economy is projected to show a modest improvement during the latter part of 1986 and through 1987. The nation's huge trade and current account deficits will top out this year, but dramatic improvements will be difficult to obtain.

Several factors are contributing to the delayed impact on trade of the decline in the value of the dollar that has taken place. First, U.S. trade is increasing with nations whose currencies have moved either concurrently with the dollar or have fallen further than the dollar. Second, the U.S. has been the engine of the recovery and the income effects of this status have kept imports high. Third, the recovery has been consumer-goods oriented, and the U.S. is a major importer of such goods. Fourth, the weakness of world commodity prices has reduced earnings from farming-product exports. These conditions generally remain in effect. Hence, they will continue to mitigate the impact on trade of the dollar's decline, suggesting only a modest improvement in trade accounts and persistently high deficits.

The dollar's decline was precipitated by declining U.S. interest rates, which reduced capital flows to levels inadequate for offsetting the huge current-account deficit. Additionally, coordinated central bank intervention coming at a time when the dollar was already falling accelerated the decline.

Recently, the rate at which the dollar has been declining has slowed, suggesting it may be near the bottom versus the key currencies and on a trade-weighted basis. The view that it is bottoming out is based on the expectation that the precipitous declines in U.S. interest rates are behind us and that any further declines will be slight. Additionally, interest rates in other countries may also decline, suggesting that relative interest rates are stabilizing. Two additional factors are the topping out of the U.S. trade deficit and the end of coordinated intervention.

Beyond these trends the dollar should also be supported by sweeping macroeconomic issues. These include oil prices, the debt of the developing world and protectionism. If oil prices at least begin to stabilize at around current levels, the negative impact on the U.S. financial system of lower prices will begin to be digested and their positive impact on the economy will become more apparent. The LDC debt issue will continue to percolate in financial markets, but with less disruption as some countries improve and the domino theory becomes less relevant. Additionally, Mexico's situation is perceived as less of a U.S. financial problem, as the stakes are raised by other industrial nations through such factors as the Baker initiative. Finally, any outbreak of protectionism would probably favor the U.S. dollar because our imports so greatly exceed our exports, and outright protectionism would tend to narrow the gap. Hence, any foreseeable shocks appear to be moderately pro-dollar.

In total, we look for a bottoming out of the dollar in the near term. But, obviously, given the magnitude of the nation's external position, no huge increase in its value is anticipated.

CALIFORNIA ECONOMIC OUTLOOK

California economic activity has continued to surge ahead since 1982, consistently outstripping the nation as a whole by a wide margin. Although annual rates of growth have tapered off following the phenomenal 8.2 percent increase of 1984, the state will still register impressive gains in 1986 and 1987. In nominal terms, California's gross state product will register combined 1986-87 growth of some $66 billion, or 13.4 percent. That nominal increase represents an estimated 13.5 percent of total U.S. Gross National Product gains for the period. After adjusting for inflation, the California economy is projected to grow a combined 8.7 percent during 1986-87, compared with a U.S. figure of 5.7 percent. The value of goods and services generated by the California economy is forecast to reach $537 billion by 1987, 12.4 percent of total U.S. output.

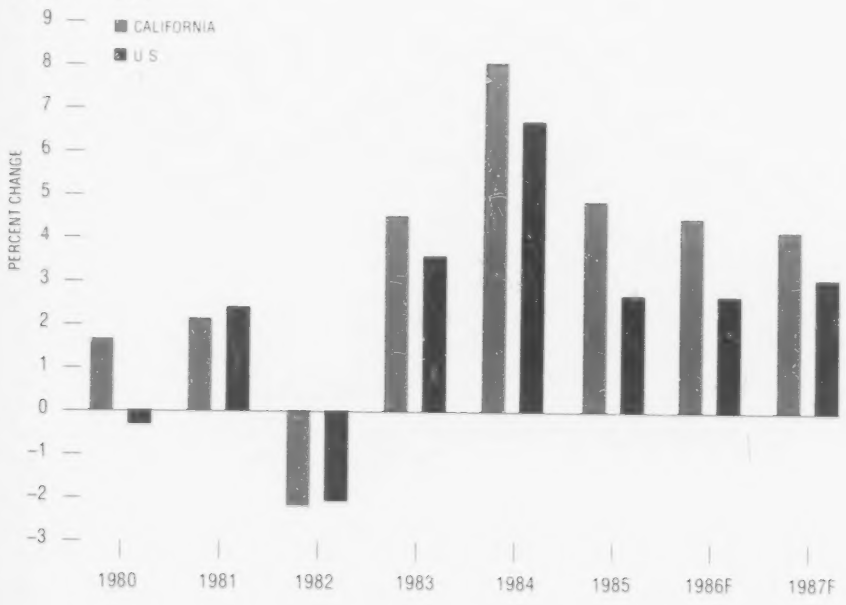
In addition to providing homes and jobs for a population of well over 26 million people as of 1985, the state will have, in 1986 and 1987, lured nearly 300 thousand new residents per year across its borders. This population growth will be on top of a natural increase in population greater than 200 thousand annually; by year-end 1987 California will be home to an estimated 27.2 million people.

Also during that short, two-year span Californians will see an estimated:

- 744 thousand new jobs created in nonagricultural industries,
- an additional $60 billion in total personal income generated,
- over $22 billion added to consumer spending, and
- 482 thousand new housing units being built.

In the sections which follow, Security Pacific Corporation will present its assessment of the major trends anticipated for California economic activity through 1987. Also, many of the state's key industries will be discussed, ranging from aerospace to agriculture, and an up-to-date evaluation of the regions comprising California will be provided.

Real Economic Growth
CALIFORNIA AND U.S.



EMPLOYMENT

The California employment scene, while appearing to maintain its robust characteristics by measures such as overall employment growth and a declining unemployment rate, is nonetheless experiencing difficulties in a number of key areas. Some of the more significant influences affecting the strength of the state's labor markets are: a still sagging agricultural industry; upheaval in the energy sector; increased competition from out-of-state and offshore; and uncertainty over the final shape of impending tax legislation. Subsequent sections of this report will discuss in greater detail the implications of the above forces on individual industries; this section

will deal with the broader view of general labor market trends.

The aging of the post World War II baby boom, resurgence of substantial migration into California, and increasing labor force participation by women have fueled the growth of the state's total civilian labor force over the past several years. Indeed, these trends will continue through this decade. Fortunately, the state's economy has grown dramatically since the recessionary 1981-82 period, even to the extent that it has generated sufficient job opportunities to accommodate the preponderance of job seekers. As a result, the state's unemployment rate has fallen from a 1982 high of 9.9 percent to a 1986 low of 6.7 percent.

During 1987 California's labor markets will reflect a slightly weaker economy and a more grudging growth in job creation. Total civilian employment will increase just over 200 thousand, compared with a 1986 gain in the neighborhood of 360 thousand. Regrettably, a growing number of job seekers will not find employment, and the state's unemployment rolls will swell to well over 900 thousand, compared with the 1986 level of 883 thousand. Thus, the state's unemployment rate will rise modestly, to 6.9 percent from the year earlier 6.7 percent, reflecting the state's inability to absorb all new and reentering workers, not a small number of whom are new entrants to California.

Employment prospects during 1987 will vary widely from sector to sector. The troubled list will include, most predominantly, agriculture and energy-related enterprises, as well as a host of durable goods manufacturing industries ranging from leather products, to nonelectrical machinery, to motor vehicles and equipment. Indeed, for all of 1987, only 7,500 net new manufacturing jobs are expected to be created. Even the much touted aerospace/high technology sector will fall short of earlier expectations as the setback in the space shuttle program continues to wind its way through the industry and as programs such as the Strategic Defense Initiative and the overall defense buildup continue encumbered by the budgetary process.

The brightest prospects for job seekers in 1987 will be in the trade and services sectors, although virtually all major nonmanufacturing sectors, including government, will be recording employment gains. Consumer spending will grow sufficiently in 1987 to warrant some 119 thousand new jobs in the trade category. An expansion of nearly the same magnitude will be seen in the services sector, with particular emphasis in the important health and business services categories. These two categories alone account for almost 50 percent of all service jobs. Moreover, the net addition to trade and service employment in 1987 will account for very nearly 70 percent of the total net increase in nonagricultural employment.

Unlike the late 1970s and early 1980s, there continues to be an expansion of government employment in the state, particularly state and local government, although federal job gains are also being registered. The strength of the state's economy since

California Employment

Thousands

				Percent Change		
	1985	1986†	1987†	1985	1986	1987
Civilian Labor Force	12,937	13,250	13,508	2.5	2.4	1.9
Civilian Employment	12,007	12,367	12,576	3.2	3.0	1.7
Unemployment	931	883	932	-5.1	-5.2	5.6
As % of Labor Force	7.2	6.7	6.9	—	—	—
Nonagricultural Wage & Salary Workers	10,994	11,393	11,738	4.0	3.6	3.0
Mining	49	44	42	-2.0	-10.6	-3.1
Construction	493	533	549	10.8	8.1	3.1
Manufacturing	2,083	2,062	2,069	0.9	-1.0	0.4
Nondurable Goods	637	639	642	-0.3	0.3	0.5
Durable Goods	1,446	1,423	1,427	1.4	-1.6	0.3
Transportation & Public Utilities	572	594	614	3.1	3.9	3.3
Trade	2,624	2,771	2,890	4.7	5.6	4.3
Finance, Insurance, & Real Estate	724	749	775	4.3	3.4	3.5
Services	2,654	2,795	2,909	5.8	5.3	4.1
Government	1,795	1,846	1,888	2.7	2.8	2.3
Federal	344	351	356	3.0	2.1	1.5
State & Local	1,451	1,495	1,532	2.7	3.0	2.5

† = forecast

1982, strong population growth, and the recognition that some state-provided services – including education – were not meeting fully the public need have helped to produce an environment in which a growing public sector is more politically palatable. This changing view is especially true against the backdrop of flagging federal support of many programs and the shifting of much of the responsibility for those programs to the states. Total government employment in California is expected to rise by over 40 thousand in 1987, with almost 90 percent of that gain occurring in state and local government.

In summary, the outlook for California job seekers in 1987 will be less bright than in the prior two years, resulting in a modest upward movement in the state's unemployment rate. Nonetheless, there will be sectors which show marked gains – predominantly in nonmanufacturing industries. Further, a comparison of employment totals in major industry groups in 1980 with those expected in 1987 reveals that there has been a subtle shift in sector dominance. Specifically, manufacturing and mining employment are losing ground to construction; trade; finance, insurance, and real estate; and service employment. In addition, although a comparison between the two years 1980 and 1987 does not reveal it, government's share of employment is also rising. The ascension of government employment is a more recent phenomenon, owing primarily to the latent effects of the taxpayer initiative known widely as Proposition Thirteen. The first few years of this decade were weighted toward reducing the size of state government, a goal which seemingly has been reversed. More recently, it is clear that government employment is a growth occupation.

PERSONAL INCOME

Total personal income in California has continued to rise strongly in both nominal and real (inflation-adjusted) terms since the weak showing of the recession year 1982. The growth in total personal income for 1987 at 7.5 percent (4.2 percent real), suggests that consumers will still command sufficient spending power to maintain this consumer-led expansion. Indeed, California's total personal income has increased an estimated 47.4 percent from 1982 through 1987, compared with a gain of 38.4 percent for the nation as a whole. Stated in dollar terms, Californians will receive $148 billion more in personal income in 1987 than they received in 1982.

In addition to rising personal incomes, Californians will continue to enjoy a strengthening in household assets resulting from higher prices of both debt and equity holdings, as well as most residential real estate. Again, because inflation will remain at modest levels through 1987, household wealth will record substantial real gains. While it is certainly possible that equity holdings will retreat somewhat from the lofty levels achieved during 1986, and, moreover, that debt holdings may be eroded as interest rates rise modestly during the course of 1987, these losses are expected to be minimal for the most part. Also, residential properties, particularly single-family homes, will see rates of appreciation approaching double digits, thus helping to offset deterioration of other asset values.

Wage and salary income will continue to be bolstered by rising levels of employment during 1987, although those gains will be tempered by both a reduced level of job creation relative to preceding years and by the efforts of employers to control labor costs. Thus, wage and salary income is forecast to grow some 8.1 percent in 1987, compared with a gain of 8.4 percent in 1986.

Similarly, proprietors' income will enjoy another year of solid gains in 1987. Although retail sales growth will ease in 1987, price increases should amply offset that decline and stimulate another year of income growth for proprietors which hovers in the 10 to 11 percent range. As in 1986, total proprietors' income will perform well in the nonfarm sector, but the farm sector will likely again experience a difficult time. On the brighter side, a growing number of agricultural observers are suggesting that the worst may be over for California's farm sector, implying that net farm incomes in 1987 will be less dismal than in 1986.

Total property income is also expected to boast 1987 gains in excess of those for 1986 due primarily to the effect of upward adjustments in interest rates and, hence, interest income. Those relying on interest income as a major contributor to total personal income have been among the principle losers over the past several years. While interest rates will not be rising dramatically during the coming year, at least the downward slide will be stopped.

For persons relying on equity-market investments as a major source of personal income, it is likely that 1987 dividend income will approximate that of 1986. Although, according to many market watchers, equity values may have already reached their peaks, the outlook for corporate profits suggests that dividend payouts during 1987 should not vary greatly from the 1986 aggregate.

One of the real uncertainties in the property income category for 1987 is rental income. There is wide diversity of views on the effects of anticipated tax changes on rental properties. One school argues that few new rental properties will be built in 1987 as a result of less favorable tax treatment. The argument goes that with fewer units coming on line, the overall expansion of the rental market will be stopped, resulting in a sharp slowing in rental income gains. Others suggest, however, that the rental market is already overbuilt and that this excess inventory is holding rents down. In this view, if the quantity of rental units available were to more closely match the quantity of rental units desired, rents could be adjusted more aggressively. A third contention, relating to residential properties, is that if landlords were in a position to push rents up suddenly and dramatically, rent control proponents would soon force legal restraints

on rental pricing which would compound whatever difficulties that market now faces.

While each of these views has merit, the evidence presently available leads us to the proposition that the effects of anticipated tax law changes will probably not have a major impact upon rental pricing in 1987, but may well have significant effects in subsequent years. At present, the inventories of both commercial and residential rental properties in California appear to be at levels sufficiently high to stem major rent increases. And, a number of projects are already in the pipeline and will be adding to inventories over the next 18 months. Finally, high vacancy rates in many areas have forced landlord concessions which preclude sizable near-term rent increases. As a result of these influences, it is likely that total rental income in 1987 will not rise substantially from the 1986 level. The combination of rent hikes and new units coming on line will lead to a total rental income gain in the neighborhood of 8 to 10 percent.

CONSUMER PRICE TRENDS

Consumer price trends in California have definitely been encouraging. Not only has an improved inflation performance materially affected interest rates and real personal income growth, it has also had a soothing effect on consumer psychology. Recalling the double-digit inflation of just five years ago, the estimated 3.6 percent increase in California consumer prices for 1986 is a major improvement.

There have been many contributors to lower inflation in 1986, but the one which stands out most is energy. Indeed, excluding the effects of lower energy prices, especially gasoline, California's consumer price index would have been some 1.5 percentage points higher in 1986. Unfortunately, at least from the consumer's point of view, the dramatic effects of lower oil prices will, for the most part, have been assimilated in 1986 and will not add the same downward bias to 1987's consumer price index. In fact, some energy industry observers contend that retail fuel prices could begin edging upward in late 1986 and in 1987. They envisage a double-edged threat which includes the potential success of OPEC in reducing output and raising oil prices, as well as the possibility that tax overhaul (federal, state, or both) will result in revenue enhancements which include higher taxes on motor fuels.

The outlook for consumer prices in 1987 assumes that oil prices will firm and will lead ultimately to some upward pressure on production costs and, in the end, consumer prices. Also, farm prices are expected to strengthen slightly in 1987, prompted, in part, by the drought in the Southeastern United States and by the exit of large numbers of farmers from agricultural endeavors. Moreover, rising residential real estate values will add to housing costs. As a result, primarily, of these influences, California's consumer price index is projected to rise 4.1 percent in 1987.

Other culprits in the consumer price outlook in both 1986 and 1987 are medical care and insurance. For both years these costs are expected to rise noticeably. Not surprisingly, there has been tremendous effort in recent years to slow the rise in medical care costs, and some successes have been achieved. Insurance carriers, also, have not enjoyed the spotlight, and politicization of this issue is expected to result in pricing and coverage modifications in the near term. It has been suggested by the insurance industry that they are in the midst of efforts which will alleviate the need for substantial rate increases.

In summary, many of the forces which held down consumer prices in 1986 will play a less important role in 1987. Actually, there will be some reversals which will be putting upward pressure on 1987 consumer prices, namely food and energy. As presently perceived, however, there is little reason to believe that there are massive increases in the offing.

CONSUMER SPENDING

Consumer spending will be the major driving force of California economic growth in 1987, even more so than in 1986. Although U.S. industrial production is forecast to rise moderately in 1987, there presently exists sufficient excess capacity to accommodate that gain without the need for significant additions to plant and equipment. Existing inventory levels of commercial and industrial space will couple with expected tax changes to subdue nonresidential construction. Also, multiple-unit residential building will likely be curtailed until the implications of the tax overhaul are interpreted for their bottom-line impact. That is, many projects now on the drawing board may not be economic under the new tax laws. Moreover, single-family construction is expected to ease in reaction to slightly higher mortgage interest rates, a paring of pent-up demand, rising home prices, and concern over future economic growth and potential homebuyers' employment prospects.

Notwithstanding the key role consumer spending will play in 1987 and recognizing that personal consumption expenditures were weaker than expected during the first half of 1986, it is still likely that consumer spending in California, as measured by total retail sales, will increase at a rate slightly above that presently estimated for 1986. Statewide retail sales are forecast to increase 7.9 percent in 1987, compared with a 1986 gain of 7.2 percent. The following paragraphs discuss the major retail-store groups.

Apparel Stores

As in 1986, it is expected that apparel stores will experience another good year in 1987. Rising personal and household incomes will continue to afford consumers the ability to replenish or upgrade their wardrobes. In particular, women's, family apparel, and shoe stores should do well. Men's apparel stores, on the other hand, will be in for a softer year as rising prices push reluctant buyers to alternative purveyors.

General Merchandise Stores

The inroads already made by high-volume, low-overhead outlets, as well as by limited-price variety stores, will be expanded in 1987, thrusting added competition onto traditional department stores. Department and dry goods stores will have to choose between lost sales or more competitive pricing if they are to maintain their current market share. Clearly, this move will require a fundamental change in marketing philosophy. Similarly, growing competition by general merchandise and discount outlets is affecting sales of drug stores, a phenomenon that is likely to persist as pharmacies are increasingly introduced into high-volume, multi-line outlets.

Specialty Stores

For the most part, specialty stores should continue to do well in 1987 as

Selected California Economic Indicators
Percent Change

	1982	198	1984	1985	1986†	1987†
Gross State Product	3.7	8.6	12.3	8.9	8.1	7.5
Real Gross State Product	–2.2	4.6	8.2	4.9	4.5	4.2
Personal Income	6.5	7.1	11.0	7.7	7.0	7.5
Real Personal Income	0.4	3.3	7.8	5.4	3.4	4.2
Retail Sales	0.3	10.9	12.0	10.5	7.2	7.9
Real Retail Sales	–5.3	7.0	8.5	7.0	3.6	3.8
Consumer Price Index	6.6	1.6	5.0	4.2	3.6	4.1
Civilian Employment	0.3	1.2	4.9	3.2	3.0	1.7
Nonagricultural Employment	–1.7	1.5	6.0	4.0	3.6	3.0
Unemployment Rate	9.9	9.7	7.8	7.2	6.7	6.9
Residential Building (000)	84	168	219	264	257	225

† forecast

consumers perceive the economy to be in reasonably good shape and as households and individuals move to enhance their cache of luxury and novelty items. Gift, art, floral, and jewelry stores should be among the better performing specialty stores in 1987, although stores specializing in recreational and sporting goods are also likely to be among the top performers. In addition, stationery and book stores should see their wares move at a reasonably brisk pace. On the other hand, photographic equipment supplies and musical instrument sales are forecast to be sluggish in 1987 with sales about equal to or slightly ahead of 1986 levels.

Eating and Drinking Places

In general, eating and drinking places will see marked growth in 1987 owing to growth in household incomes and perhaps more importantly, rising consumption of food away from home, and of food eaten at home but prepared elsewhere. This trend represents an ongoing change in lifestyles and consumer preferences. Notably, the difficulties of the farm sector, which have held down agricultural commodity prices, have had a favorable effect on food purveyors, including grocery stores. Significant price increases have not been forced on retailers, and specials have been varied and substantial for consumers. This trend is expected to continue through most of 1987 in the absence of dramatically firmer farm commodity prices.

Building Material Group

As in 1986, the building material group will record a rather modest 1987 gain in overall sales because of the drag associated with the farm sector and farm implement dealers. When that component is excluded, the building material group's performance looks much better. Unlike 1986, however, a somewhat weaker housing outlook – particularly new construction – will limit sales gains. Even so, household and home furnishings and household appliance retailers should be among the top performers in the group in 1987. Likewise, lumber and building materials and plumbing and electrical supplies should be near the top of the group as consumers pursue improvements and additions to existing homes. Nursery and garden supply stores will share in this growth.

Automotive Group

New motor vehicle dealers, which account for over 50 percent of this group's total sales, and more than 10 percent of total taxable sales in California, are likely to be facing a more difficult year in 1987. Price increases, diminishing factory incentives, higher interest rates, and growing competition will work against dealers and make it difficult to exceed 1986 dollar sales volume. It would not be surprising to see dealer incentives playing a greater role in 1987 marketing schemes. Nor would a reduction in dealer margins be startling.

Service stations, which account for the second largest share of automotive group sales (some 32 percent) are not forecast to rise substantially in dollar terms in 1987, although unit sales gains should continue as California and out-of-state drivers take advantage of lower-priced gasoline. This trend could be offset somewhat if the OPEC production agreement of August 1986 proves successful. In that event, although retail dealers' net profits might be little affected, gross dollar sales would likely be enhanced because of higher pump prices resulting from higher factor costs.

Recreational vehicle dealers, which have done well in 1986 because of lower gasoline prices and favorable consumer financing, can expect to see a continuation of that trend in 1987, although slightly higher interest rates and the threat of rising fuel prices may diminish their gains. In spite of these negatives, advancing economic growth suggests that the quest for recreation will not be suppressed significantly in 1987.

CALIFORNIA INDUSTRY TRENDS

AEROSPACE/HIGH TECHNOLOGY

For many of California's aerospace contractors, 1986 and 1987 will be very good years in terms of sales and profits, in spite of the pending threat of deep cuts in the nation's defense budget. The reason: a large backlog of defense orders that will continue the momentum of earlier defense spending for at least another year. In addition, commercial aircraft orders should be peaking in the next two years.

However, for fiscal year 1988 and beyond, prospects for the state's aerospace industry become a bit dimmer. The nation's number one priority of defense rearmament has given way to curbing hemorrhaging budget deficits. Budgetary pressures threaten to exact deep cuts in the defense budget, and are sure to affect aerospace contractors right here in the state.

A likely scenario is either a defense budget tied to inflation (zero real growth), or a freeze in defense appropriations at their current levels, resulting in negative real growth. Meanwhile, the growth rate in actual defense outlays for 1986 and 1987 will be half the rate exhibited during the 1981-1985 years. It will then flatten out in 1988, before actually declining in 1989.

Whatever the scenario, it is clear that defense contractors in California will have to make do with a lot less defense monies than they have had to in the past five years. Between 1981 and 1986, California's share of U.S. prime defense contracts rose from 16 percent in 1981 to an estimated 19 percent in 1986. However, California's share of U.S. prime defense contracts will slowly begin to reverse itself for the remainder of this decade.

For California's economy, the overall *aggregate* effect of this reversal in defense spending will be minimal. The reason is California's large and diversified economy, which is expected to soften the impact of declining defense expenditures. The share of final demand currently attributable to defense will decline, as defense expenditures are cut back and California's other industries continue to grow and pick up the slack. In 1986, defense expenditures will account for nine percent of the state's nominal gross state product. By 1990, final demand originating from defense expenditures will have fallen to seven percent of California's nominal gross state product.

Nevertheless, the economic impact of lower defense spending will affect certain regions and industries of the state disproportionately. Defense spending is vitally important to California's manufacturing sector and particularly the state's aerospace and electronics industries. A sizeable amount of total manufacturing output occurs in the aerospace industries of aircraft and missiles, communications, electrical equipment, electronic components and semiconductors – all of which are heavily involved in defense-related production. As a result of the expected downturn in defense spending, aerospace employment will be virtually flat in 1986 and 1987, and will begin to decline in 1988 when large production contracts begin to be phased out. Already we have seen rather large layoffs by some of the state's major defense contractors in expectation of "leaner" times.

Los Angeles and Santa Clara counties will be hurt the most from a downturn in defense spending in the coming years. Los Angeles county alone accounts for almost half of all prime defense contracts in the state. Meanwhile, Santa Clara county receives the highest per capita dollar amount in defense prime contracts in California, nearly triple the state average. Other regions expected to be affected negatively as a result of lower defense spending include Orange and San Diego counties. On the other hand, Alameda county – because of the presence of Lawrence Laboratories – is expected to prosper because of increased Federal nondefense expenditures and the influx of R & D dollars for the President's star wars program.

For now, any further cuts in defense will result in reduced personnel, operating and maintenance costs. However, prolonged and sustained cuts in the defense budget will eventually make themselves felt in the area of procurement, which involves the production of new weapons systems. Some weapons programs are sure to be stretched out while others are reduced in size. New starts on other programs will be deferred for a later time. However, few if any major programs will actually be cancelled outright. As future defense budgets become leaner, the Defense Department will be faced increasingly with the tough choice of deciding where its spending priorities lie: with high technology strategic weapons or with low technology and conventional land warfare weapons.

The amount of subcontracting and outsourcing is expected to

increase over the next few years as a result of these changes in priorities. Traditionally, half of all prime defense contracts have required some sort of subcontracting work to be done. However, a significant amount of this subcontracting work is done out-of-state, representing a huge dollar loss to the state's economy. The trend toward more subcontracting will add to these losses in future years. Somewhat mitigating this negative impact will be the increased amount of electronics work that will be opening up for many of California's electronic firms as a result of more subcontracting. Electronic components have often accounted for as much as two-thirds of the work on some defense projects.

Also generating more business for the electronics industry will be the shift away from the production of new weapon systems toward the upgrading and modification of already existing weapon systems. Increasingly sophisticated weapons will require electronic components that can be quickly identified and repaired or replaced. Thus, the Defense Department will be generating a greater demand for spare and repair parts.

Because electronic firms stand to do well in this new environment of lower defense expenditures, many of the larger defense contractors in the state have begun shopping for promising candidates for acquisition in these growth areas. This trend is expected to continue in 1987. In addition, we can expect major contractors to team up on future projects, pooling their resources in hopes of avoiding internecine competition and being shut out of bigger but fewer defense contracts.

As mentioned earlier, not all the news pertaining to the aerospace industry is bad. Increased production of commercial aircraft is sure to take off in 1987 and 1988 as a result of the greater worldwide demand for modern planes to replace aging fleets. Another contributing factor will be the drop in oil prices, enabling the airline industry to realize large savings in the form of lower operating costs, and helping them to expand and/or modernize their existing fleets. Finally, deregulation of the airline industry and moderate growth in the discretionary incomes of most Americans has afforded the opportunity for increased airline travel and hence the

demand for more planes. It should be pointed out, however, that current fare competition has largely offset the positive effects of lower fuel costs.

So far in 1986, California's high-tech industries are experiencing somewhat of a mixed bag but with slightly encouraging prospects for 1987. Though no precise definition of high-tech industries exists, high-tech firms can be characterized by the extensive amount of research and development they do, and by a workforce staffed with a high ratio of technical, scientific and engineering personnel, typically 10 percent or more. Examples of high-tech industries include electronics, computers and office equipment, aerospace, communications, and instrument manufacturing.

The severe problems that dogged many high-tech industries in 1985 – lagging sales and excess inventories of goods and raw materials – began to turn around in 1986. However, any improvement in sales is likely to be due to sizeable cuts in prices, leading to lower revenues and smaller profit margins. Given the competitive nature of these industries, prices are expected to continue falling in 1987.

Ironically, the spectacular success of high-tech industries in California, and elsewhere in the United States, has led to this price cutting trend by attracting competitors worldwide, forcing down market prices. In the absence of any major technological breakthrough, the meteoric growth rates witnessed in past years will be replaced with moderate but more realistic rates of growth. Shakeouts, such as those witnessed in the computer and software industries in 1985 and 1986, are expected to continue into 1987. The decline in the value of the U.S. dollar, hailed as the cure for what ails high-tech manufacturers, has instead left a bitter taste in their mouths. It has become increasingly apparent that while a cheaper dollar will slow the influx of imports into the U.S., foreign manufacturers have no intention of giving up their hard-fought inroads into U.S. markets. Instead, foreign manufacturers are quite willing to sacrifice reduced margins in order to maintain their market shares. The bottom line is that import competition will continue to batter particular high-tech industries. Already much of high-tech manufacturing done in California has been shifted overseas or across the border to Mexico to take advantage of these countries' lower wage rates.

Another contributing factor is the general malaise in manufacturing, affecting both high- and low-tech firms. Contrary to commonly held beliefs, high-tech industries are not insulated from the vagaries of the traditional business cycle. Many of today's high-tech industries require relatively little start-up capital, which makes them susceptible to foreign competition.

Along similar lines, technology exports from the U.S. into developing countries has become more commonplace than just five years ago. The ability to acquire technology transfers easily and quickly results in greater competition, faster product introductions, quicker obsolescence of existing products, and greater marketplace uncertainty. The results will be more shakeouts, such as those occurring in the computer and semiconductor industries. Software developers and peripheral hardware suppliers are also feeling the pinch as a result of weak computer sales.

A comprehensive rebound in high-tech industries is tied heavily to the performance of the nation's economy in 1987. Until now, lackluster sales and a great deal of unused capacity have inhibited investment spending in many key United States industries. Capital spending is critical to high-tech firms since much of the demand for their products is investment spending by other businesses. The important office and computing sector alone accounts for 25 percent of U.S. capital spending. However, capital spending budgets have been slashed dramatically this year due largely to a weak manufacturing sector. In addition, tax reform uncertainties – especially the fate of accelerated depreciation and investment tax credits – have caused many businesses to adopt a "wait and see" attitude.

The year 1987 will be uneventful for computer sales and the information processing industry. A less-than-robust economy and highly leveraged consumers and businesses threaten to put a crimp in sales. Unit sales for the most part will outpace their 1986 performance, but continued price cutting will eat into total revenues. Inventory rebuilding will help offset some of this weakness, as businesses seek to build up inventory levels in anticipation of a slightly stronger economy in 1987.

CONSTRUCTION OUTLOOK

In 1985, residential building permits in California totaled over 263,000 – a 20.5 percent increase over 1984's total of 218,000 permits, and the highest number in the state since 270,000 permits were filed in 1977. In a year when several sectors of the state's economy were besieged by problems – most notably agriculture and manufacturing – California's ebullient housing market was a major force driving the economy. The return of mortgage interest rates to single digits, a level not seen since 1978, created a flurry of housing activity as Californians rushed to take advantage of the lower rates.

During the first half of 1986, residential building permits proceeded at a seasonally adjusted annual rate of 275,000. We anticipate that permit activity will cool off in the second half of 1986. Security Pacific's forecast calls for over 257,000 permits to be filed in California in 1986, a drop of only 2.5 percent from 1985's total. Our mortgage rate forecast calls for long-term fixed rate mortgages to bottom out at 9.25 percent by the fourth quarter of 1986, thereafter rising to 10.0 percent in the spring of 1987, before finishing the year at 10.5 percent. As a result of our mortgage rate assumption and commensurate with a largely filled pent up demand, Security Pacific is forecasting residential permits of 225,000 in 1987, a drop of 12.5 percent from 1986.

Despite that decline, 1987 will be the fourth year in a row that residential building permits surpassed 200,000. The only previous time this has occurred in California was between the years 1976 and 1979. Unlike that earlier period, however, California's present day housing boom has been triggered by solid economic fundamentals (lower mortgage rates and pent-up demand), as opposed to speculative market behavior fueled by runaway housing inflation, which was the case during the middle and late 1970s. The large drop in mortgage rates has afforded more Californians than ever the opportunity of purchasing and owning a new home.

Residential construction activity will continue to concentrate in the more populous areas of the state, with two-thirds of all new projects occurring in Los Angeles, San Diego, San Bernardino, Orange, Sacramento and Riverside counties. On a percentage basis, the greatest growth will occur inland in counties near major metropolitan areas. Strong residential construction growth in Riverside, San Bernardino and Sacramento counties will be facilitated by an abundance of available land that is considerably cheaper than that of surrounding neighbors.

After remaining dormant for three years, housing prices in the state took a giant leap in 1985, with the median price of existing homes shooting up 12.3 percent. Between 1982 and 1984, the median price for an existing home in California increased at an annual rate of 1.4 percent. In the first five months of 1986, the median price of existing homes averaged monthly increases of 2.6 percent. The median price of an existing home will increase by 12 percent in 1986, raising the average median value from $123,000 in 1985 to $137,000 in 1986. The reason: the tremendous surge in housing demand coupled with dwindling inventories of unsold homes. Housing prices will increase by an additional 10 percent in 1987. In addition, housing prices will vary within the different regions of the state, with higher-priced homes located in coastal areas and lower-priced homes in inland parts of the state.

Most of the housing activity taking place today is in the trade-up market, with many home buyers moving up to a larger home with more amenities. Three-bedroom homes are the first choice for many of these buyers. The state's vacation home market has also benefitted greatly from lower mortgage rates; the expected preservation of interest deductions on second homes will help support this market.

Ironically, the housing market for potential first-time home buyers has weakened since 1985. Tighter lending rules and larger required down payments have effectively shut out many Californians seeking to purchase their first home. Home foreclosures have increased to uncomfortable levels for many lenders, causing them to scrutinize more closely an applicant's credit and income history.

Despite a strong demand for single unattached homes, a great deal of permit activity is still occurring in the multi-family sector. In 1985, building permits for multi-family dwellings totaled over 153,000 or

58 percent of all permits filed that year. During the first half of 1986, multi-family permits have been proceeding at a seasonally adjusted annual rate of 150,000.

Part of the explanation for such large numbers in multi-family permits is the tax reform currently under consideration by the Congress. In its current form, tax reform threatens to eliminate a sizeable number of real estate tax shelters. It would do so by lengthening the number of years in which investors are able to depreciate real property, and by lowering marginal tax rates so that the after-tax benefit of owning these properties would be reduced. In addition, the extension of at-risk rules to real estate would limit drastically the dollar amount investors are able to shelter as tax write-offs. Another factor contributing to 1985's sharp gain in multi-family permits was legislation requiring new public buildings to be accessible to the handicapped, causing a large surge in multi-permits to occur in order to beat the September 1985 deadline.

Vacancy rates for multi-family dwellings have been inching upwards since 1985, and will continue to do so on into 1987. Despite this fact, multi-family construction has continued strong in 1986, but will slow appreciably in 1987. A shrinking pool of renters – many of whom have opted to take advantage of lower mortgage rates and become homeowners – has created soft rental markets throughout the state and forced landlords to scramble for the remaining pool of tenants.

Overbuilding and low appreciation rates have eaten into rental incomes. The stock of apartment buildings, has tripled since the early 1980s, and is approaching levels reminiscent of the go-go years of the early 1960s. Hard times in the oil and computer industries have also contributed to slackening rental demand. Starter homes, condominiums, townhouses and manufactured homes are also doing relatively poorly in 1986 due to the increased supply of affordable new and existing homes. Prospects for these markets are only slightly encouraging in 1987.

Nonresidential construction in 1985 was up strongly for the third year in a row, with total permit valuations up 11 percent, or $13.3 billion, from 1984. However, nonresidential construction appears to be approaching the end of its current building cycle. The current cycle can be characterized by rising vacancy rates and a subsequent slowdown in building activity, only to be followed by a space shortage triggering the next construction cycle. Nonresidential construction has already begun to cool off in 1986, and will continue to do so in 1987, due to rising vacancy rates in the important commercial sector which has typically accounted for half of nonresidential valuation. Nonresidential valuation in 1986 is expected to total $12 billion, a drop of 9.8 percent from a year earlier, and will rise only slightly in 1987, to $12.5 billion.

Because of overbuilt conditions, rent concessions and other incentives will persist as developers seek to lure tenants. While California's major metro areas have healthy absorption rates, segments such as the office market have a two year supply of office space with more construction projects in the pipeline. Therefore absorption rates alone will not be able to sop up all the available office space on the market any time soon, and construction of commercial projects is expected to be scaled back.

The hotel/motel market is also experiencing rising vacancy rates that are slightly higher than the U.S. average, with certain areas of the state facing overbuilt conditions. The much ballyhooed boom in tourism, as a result of relatively inexpensive gas, a cheaper dollar, and fears of terrorism abroad, has failed to meet expectations. Construction activity in this market segment will cool off in 1987. In addition, the construction of retail stores will also wane in 1987 due to weaker retail sales growth, with the possible exception of Sacramento, Riverside and San Bernardino counties, thanks to anticipated strong population growth in those areas.

Industrial construction valuations declined in 1985, due in large part to the downturn in the electronics industry, which caused vacancy rates to soar and the number of construction projects to diminish. In 1986, valuations have remained relatively flat because of the drop in oil prices and its impact on energy-related building projects, which have been scaled back, postponed, or cancelled. The year 1987 will show a small gain in industrial construction,

as a result of the expected modest improvement in the state's manufacturing sector.

Construction in the institutional category has done well in 1986, and is projected to do well again in 1987. The drop in interest rates has paved the way for many California municipalities to refinance their debt and spend the savings on infrastructure needs. In addition, for the second year in a row, the state budget includes a significant sum of money for major highway construction projects and repairs.

Because construction is such a basic industry, building-related businesses have benefitted enormously from housing's continued strength. Building materials manufacturers have done brisk business as a result of the boom in housing. Rising home sales have managed to pull up furniture sales as consumers shop for items to fill their new homes. Lower mortgage rates have also proved a boon to the home renovation industry. Not surprisingly, the strength in housing has generated strong employment growth in the construction sector.

In 1985, employment gains in construction registered a 10.8 percent increase, the addition of almost 50,000 new jobs. Construction's continued vigor in 1986 will result in an additional 40,000 new jobs for a gain of 8.1 percent – the largest percentage increase of any major employment category that year. Because construction is expected to abate from its heady pace of 1986, employment growth in 1987 will be only 3 percent, or the addition of 16,000 new construction jobs.

TOURISM

Based on spending by travelers,* California is the number one visitor state in the nation. Almost 100 million U.S. citizens travel in the state each year, about half of whom come from outside California. In terms of overseas visitors, California is the leading state in the nation, with most of the foreign travelers coming from Canada, Japan, and Mexico. About 90 percent of the state's travel revenues come from domestic visitors. This section focuses on recent trends and the outlook for California's tourism industry.

Nationally, the travel industry is estimated by the U.S. Travel Data Center to have generated over $242 billion in 1985 or about 6 percent of the gross national product. Almost 13 percent of U.S. travel spending took place in California. The state's estimated revenues of $30.8 billion by domestic visitors was a gain of 8.2 percent from the previous year and outpaced the 8.0 percent gain in the U.S. as a whole.

While the state, like the nation, is experiencing a year of modest economic gains, indicators are generally positive for the travel industry. Overall, the visitor industry is likely to have an increase in trips and a moderate gain in revenues.

While not completely without the potential for disappointment, 1986 should bring in record visitor industry revenues for the state. Travel-generated revenues, or expenditures, by domestic vacationers, business travelers, and conventioneers this year are projected to exceed $33 billion, the highest level ever for the state. The 1986 percentage increase is slightly above that expected for the U.S., 8.1 percent versus 7.9 percent. After adjustment for inflation, the revenue gains this year should give the industry its second best gain in

*The travel industry statistics generally count revenue from trips that are at least one hundred miles distant or require a night away from home.

TRAVEL INDUSTRY REVENUES
California and the U.S.
1978-1986

CALIFORNIA

Year	Traveler Expenditures ($Millions)	% Growth
1978	15,167.4	
1979	19,128.2	26.1
1980	21,882.6	14.4
1981	23,941.3	9.4
1982	24,587.1	2.7
1983	25,942.4	5.5
1984	28,476.7	9.8
1985e	30,800.0	8.2
1986f	33,300.0	8.1

UNITED STATES

Year	Travel Expenditures ($Billions)	%Growth
1978	130	
1979	144	10.8
1980	175	21.5
1981	192	9.7
1982	198	3.1
1983	208	5.1
1984	224	7.7
1985e	242	8.0
1986f	261	7.9

e = estimate f = forecast

Notes: 1985 and 1986 California revenues estimated by Security Pacific Bank.

Sources: California Office of Tourism, U.S. Travel Data Center, Security Pacific Bank.

real terms this decade. Foreign travelers visiting California for business and pleasure will increase the state's travel revenues by about $3 billion. The outlook for the visitor industry will be affected by a variety of factors, some of which are unique to this year and some of which are longer-term trends.

Low gasoline prices are encouraging domestic auto travel. While trip volume is likely to increase, revenues will be held down because of the lower gas prices.

Airline deregulation has caused competitive pricing and marketing to reach new heights, which should encourage more travel into—and out of—the state, with the effect on revenues mixed.

Lodging occupancy rates will continue to decline in some areas of the state due to record building. Increases in room rates will remain low, encouraging travel.

The dollar's lower value this year against many foreign currencies will encourage foreign visitors to travel in California.

Continuing concerns about travel safety abroad is discouraging some travel to Europe. European travel by Californians would likely have fallen this year in any case due to the decline in the dollar's value. Some increase in domestic travel spending is likely, but other alternatives such as delayed trips and shifts to other foreign destinations are also expected.

Conventions should be well attended throughout 1986, with low travel-related inflation rates encouraging longer stays for recreation/vacation.

Consumer confidence will affect the final decision on whether to spend discretionary dollars on travel. The Conference Board's Consumer Confidence Index, though remaining high, is somewhat below its last high point reached at the end of 1984. Consumers have tended to be more cautious about travel spending in periods of uncertainty.

Some longer term trends will also be affecting California's travel industry.

Demographics are generally favorable to the travel industry, with two-wage earner families more common and a large segment of the population entering the middle and older age group. Increased emphasis on market segmentation is already prevalent in the industry to identify the changing needs of consumer groups.

While California has almost unparalleled natural attributes, a dynamic economy, a recreation-oriented lifestyle, and an excellent reputation as a vacation attraction, the competition for travel spending has intensified, and other states are targeting tourism as a growth industry for their economies.

Competition for travel will also come from alternative uses of recreation and leisure time.

Surveys have indicated that vacation and recreation travel is increasingly being split into more frequent, shorter trips which should benefit the state. About 75 percent of the recreational trips in California are by state residents and by visitors from other western states.

INTERNATIONAL TRADE

Over more than a decade, international trade has played an increasingly important role in the state's economy. Since 1970, the volume of international transactions through the state's customs districts has tripled in price-adjusted terms.* However, much of the growth in international trade activity through the state took place in the 1970's while the worldwide recession in the early 1980s was reflected in a dramatic slowing in the growth of California's foreign trade activity. Growth in the state's total trade picked up after recovery got underway in late 1982. Most of that increased activity resulted from a surge in imports, which continue to run well ahead of the state's export activity.

The state of California includes three customs districts—Los Angeles, San Francisco, and San Diego. Together, the three districts accounted for 17 percent of total international trade for the U.S. during 1985. Nationally, Los Angeles ranked second (behind New York) in total international trade, and San Francisco ranked sixth.

California's location makes the state the major U.S. gateway to the Pacific Rim countries, and those countries account for roughly 75 percent of the total trade through California's customs districts. Japan is by far California's single largest trading partner, with total trade topping $35 billion in 1985. Second- and third-place Taiwan and South Korea had total trade in 1985 valued at $8.1 billion and $6.8 billion, respectively. Canada is also an important trading

* The international trade figures reflect the movement of commodities through California's ports and airports, not the points of origin or ultimate destinations.

partner for California, with two-way trade reaching $6.4 billion* in 1985.

Data for the first five months of 1986 show slow import growth and annual declines in exports through California's customs districts, resulting in a continued worsening in the trade balance. Comparing the first five months of 1986 with the corresponding period of 1985, imports through the state's customs districts increased about 6 percent while exports were off more than 10 percent.

Several factors made it difficult for California exporters to sell their products abroad. Among these were reduced demand for capital goods and the sluggish recoveries of many leading import markets, particularly among large industrial countries. Moreover, the lag between changes in currency valuations and their effect on trade contributed to a weak trade performance.

The January-May 1986 data show that the value of all but one of the major export categories was below the corresponding year earlier totals. The one exception – aircraft and spacecraft – registered a year-to-year increase in value of only 0.7 percent. Annual declines of more than 30 percent took place for the major export groups of cotton, petroleum and products, and recording equipment. Somewhat smaller, though still double-digit, declines were accounted for by other leading export categories – electronic components and instruments, automatic data processing and office machines, and earth-moving equipment.

While up overall, import activity through the state's customs districts showed mixed trends during the first five months of 1986. Double-digit year-to-year gains were experienced by imports of motor vehicles, office machines, footwear, as well as boilers, motors and engines. However, imports into California declined significantly for a number of other leading categories, including wearing apparel, iron and steel, electronic components, and petroleum products.

Notwithstanding the moderation in the dollar's value, the state's agricultural exports have been limited by modest economic growth abroad, a worldwide deflation of commodity prices, and increased foreign production and exports of agricultural products. The adoption of higher-yield technologies by foreign producers and greater incentives for domestic production by governments abroad have increased local crop output in Latin America, Asia and Europe. Countries such as India, Thailand, and South Korea, which at one time were major markets for U.S. farmers, have become more self-sufficient in their food supplies. These trends, along with continuing high levels of

California's International Trade Trends
1980-1986

*Canadian trade data, courtesy of the Canadian Consulate General. These figures reflect Canadian trade destined for or originating in California.

market interference, have significantly limited U.S. participation in world trade in agricultural commodities, a situation which the current U.S. farm bill is attempting to reverse.

It is also important to keep in mind that while the dollar has weakened significantly against the yen and the European currencies, it has remained relatively strong against many other countries that compete with U.S. agriculture. Among these are Canada, Australia, and Brazil.

Regarding exports of manufactured goods, a pickup in activity is likely to take time due to the lag between shifting currency values and the results of export activity. Also, while continued economic recovery among major U.S. trading partners is a positive force for U.S. exporters, foreign demand for capital goods is likely to increase slowly, and the outlook for high-tech exports remains limited by soft demand for electronic equipment plus intense foreign competition.

Over the longer term, the important role played by the U.S. in the manufacturing of aerospace and high-technology products should enhance demand for machinery and electrical equipment shipped from California's ports. Prospects for export activity will also benefit from the stabilizing influence of low inflation rates in the U.S. on the prices of exported goods.

The outlook for a weaker U.S. dollar will have a moderating influence on import activity through California's customs districts. Assuming no major changes in U.S. trade policies, the growth in imports through California's customs districts should moderate in coming months, and the state's trade deficit should begin to decline slowly. To be sure, the fact that imports are a dominant force in many product categories – particularly in the consumer goods and office equipment sectors – adds strength to the outlook for those import items. However, growth in dollar volume of the state's imports should remain well below the double-digit annual rates of the late 1970s.

Over the longer term, California's international trade prospects appear more promising than over the next few months. The pattern of trade in the United States has shifted to include a greater proportion of trade with Asia. In 1978, the East Asian and Pacific Island nations surpassed Western Europe as the leading U.S. trading region and have extended their lead since that time. Growth rates for Pacific Rim countries are not expected to match their strong performance of the 1970s, and the immunity of some Rim countries to external shocks likely has lessened. However, because many Asian nations have the potential for producing relatively favorable performances versus other world regions, California – as the principal U.S. gateway to the Far East – stands to benefit from trading activity.

AGRICULTURE

Total cash receipts paid to California agricultural producers were $13.9 billion in 1985, down from 1984's $14.2 billion. Lower commodity prices were the major reason for the reduction in cash receipts.

The value of agricultural exports from California also fell in 1985, to an estimated $2.7 billion. This figure represents a steady decline that began after California agricultural exports peaked at $4.2 billion in 1981. Major causes of this export slump include the highly valued American dollar experienced in previous years, weak economic growth abroad, and expanded agricultural production in foreign countries. In fact, many countries that were previously buyers of California agricultural products have actually become competing exporters.

Despite moderate increases in the cost of energy, agricultural chemicals, and labor, net income before adjustments for inventory is expected to register a decrease of five to ten percent in 1985 from the previous year's figure of $3.3 billion. Even though interest rates have declined significantly, the overall debt burden on California agriculture, more than $17.7 billion at the beginning of 1985, contributed to higher production costs. However, this debt burden is expected to decline slightly in 1986 and 1987. Since approximately one-third of California agricultural producers owe about two-thirds of the state's farm debt, many agricultural producers continue to experience greater difficulty with profitability.

Primarily as a result of declining farm income and the absence of anticipated inflation, agricultural real estate in California has depreciated sharply. However, the rate of depreciation has slowed in 1986 and land values are likely to stabilize in 1987-88. The United States Department of Agriculture reports that agricultural land values in California have depreciated by nearly twenty percent since 1983. Many observers feel that such reports underestimate

the actual depreciation because they are based on surveys – not comparable market sales.

Production conditions have varied greatly in 1986 from region to region in California. Freezing temperatures early last winter did minimal frost damage, but provided a beneficial dormancy period for trees and vines. However, temperatures during remaining winter months were moderate, resulting in an early season. Most crops have been about two weeks early, and many harvests have been hurried causing some quality and operational difficulties. Additionally, winter storms caused some flooding and hail damage. Heavy precipitation also inhibited pollination during bloom periods. This was especially a problem in northern California on crops such as almonds.

Production will also be reduced in 1986 because of expanded farm programs authorized by the Food Security Act of 1985. The Federal government is requiring significantly higher acreage-set-asides of growers participating in price support programs. This requirement will sharply reduce production of cotton, rice, and other grains. About 10 percent of California's dairy production will be eliminated by removal of dairy cows to quality dairy operators for cash payments from the Federal government. This reduction has also adversely impacted the marketprice of alfalfa hay and beef cattle in California.

Market prices for many vegetables, fruits, and nuts have improved, partially offsetting the reduced yields. However, prices for field crops remain very depressed because of excessive surpluses domestically and world wide.

Positive factors that will eventually encourage California agricultural exports are a sharply depreciated American dollar and discounted export prices for commodities supported by the Federal government. However, during most of 1986, export sales continued to decline because buyers were both clearing their inventory and anticipating even greater discounts. Importantly, exports are not expected to rebound sharply, even in 1987, because of continued trade barriers and subsidized farm production by foreign countries.

The bright spot for California agriculture in 1986 and 1987 is on the production-cost side. Plummeting oil prices have reduced the cost of fuel and agricultural chemicals. Rising electricity rates have been moderated by both lower energy costs and abundant availability of hydropower. Furthermore, sharply lower short-and long-term interest rates have reduced the cost of financing for many agricultural producers. As a result of greater Federal subsidies and lower production costs, net income is expected to increase modestly this year.

While sales of agricultural real estate in California remain relatively inactive, indications are that more serious interest is being expressed by potential buyers. Such investors are trying to anticipate the "bottom of the market." Other owners of farm real estate with sufficient equity represent the majority of parties initially interested in buying agricultural real estate at discounted prices. Outside investors want more assurance of consistent, real returns. While land prices may be stabilizing, no rebound is expected in the next few years because of numerous parcels that will be placed on the market to assist troubled farmers and ranchers in restructuring their finances.

The outlook for California agriculture over the next few years is a continuation of current trends. Some agricultural operations will expand to take advantage of lower land prices and to benefit from greater economies of scale. Depreciated land prices will provide the state's properly positioned agricultural producers the opportunity to be more competitive in world commodity markets.

CALIFORNIA'S REGIONS

The following articles discuss economic trends and the outlook for the state's three regions—Southern California, Northern Coastal California, and the Central and Mountain counties. The map on this page shows the geographical definitions of those areas.

SOUTHERN CALIFORNIA

Like the nation, Southern California's economy experienced generally moderate growth during the first half of 1986. The region's residential building activity accelerated from 1985's already high levels, fueled by lower mortgage rates and a continued strong pace of multifamily dwelling activity. However, other key indicators, such as employment and total manufacturing activity, registered relatively modest increases. In general, the lower interest rates, sharply reduced energy prices, and significant depreciation of the U.S. dollar during the first half of 1986 provided less stimulus to Southern California's economy than had been anticipated.

Moderate expansion is expected to characterize Southern California's economy through 1987, and the Southland's industry mix will likely enable the region to continue expanding faster than both the U.S. as a whole and the balance of the state. However, mixed trends characterize Southern California's important aerospace-electronics and tourism industries, and the energy sector is experiencing weakness. Inflation is anticipated to remain under 4.5 percent while continued low interest rates should stimulate sales and construction of single-family homes. Both of these trends should benefit consumer spending, which should nonetheless be limited by moderate job gains.

An important indicator of Southern California's overall growth path is the trend in total nonfarm employment. Annual expansion in total nonfarm employment for the region's six metropolitan counties averaged around 3 percent during the first half of this year—less than half the strong pace of the early stages of the recovery. However, the Southland's rates of growth in nonfarm employment during the first half of 1986 compare favorably with the trends for the U.S. and the state's Northern Coastal and Central & Mountain regions.

A mixed outlook is likely for the Southland's labor markets over the

next 18 months, with the service-producing sectors continuing to account for much of the job gains. Overall, the pace of job growth is likely to be slightly above the first half 1986 pace; annual rates of increase should average between 3 and 3.5 percent. Jobless rates over the next 18 months are expected to rise somewhat from the current low level of about 5.5 percent, as job growth remains modest and the recently high levels of net migration are translated into labor force growth.

Looking at the region's major industries, a mixed pattern is likely to characterize Southern California's important aerospace-electronics group over the next 18 months.

The commercial aircraft industry has been experiencing an uptrend in orders, with production expected to remain at high levels over the next several years.

With deficit reduction now a top priority in the federal budget process, defense contractors are likely to be faced with declining defense budgets over the next few years. However, backlogs of equipment already ordered but not yet received continue to benefit defense contractors, and this favorable influence is likely to sustain activity in the region well into 1987.

The electronic components sector has experienced significant declines during the last couple of years, and recovery for this sector still seems some time off. While demand for semiconductors from the computer, automotive, and military sectors should begin to trend upward over the next 18 months, the upturn is likely to be slowed by strong foreign competition and an outlook for only modest expansion in the computer industry.

Aerospace-electronics employment in the Southland has recorded yearly growth rates of between 4 and 6 percent over the past three years. Slower rates of annual growth are expected over the next 18 months.

Another important basic industry in the Southland is tourism. While visitor expenditures in Southern California were generally expected to set an all-time record this year, early summer business for some of the region's hotels and attractions was down from comparable 1985 levels and well below some expectations. Nonetheless, several factors continue to be favorable to the region's tourism sector. Relatively low gasoline prices have been encouraging domestic auto travel, and a lower-valued U.S. dollar than in 1984 and 1985 has spurred an increase in foreign visitors to the U.S. Also, the continued growth anticipated in consumer spending for the second half of this year and in 1987 is a positive influence on tourism activity. However, other areas of the U.S. are targeting tourism as a growth industry for their economies, and competition for the region's visitor industry also comes from the alternative uses of discretionary dollars such as for video products, sporting goods or computers.

Consumers have played an important role in the current economic recovery—both nationally and in Southern California. However, retail sales gains in recent months have slowed—a result in part of a slower growing labor market and concerns about consumer debt. Also important is the fact that pent-up demand for durable goods from the 1981-82 recession, which played an important role in 1983 and 1984, is no longer a source of stimulus.

Some increase in the pace of consumer spending is anticipated over the next 18 months. While spending stands to be limited by sluggish rates of employment and income growth, the upturn anticipated in the housing market should provide stimulus. Consumer spending also should benefit from relatively low interest rates and energy prices.

An important contributor to the economic recovery underway since 1983 has been housing. The latest data show the Southland's housing unit authorizations at the highest level since the late 1970s, with much of the activity occurring in the multi-family dwelling category.

Over the next 18 months, the single-family home market is

Selected Economic Indicators: Southern California

	1983	1984	1985	1986e
Growth in Nonag Employment %*	1.5	6.3	3.7	2.9
Growth in Manufacturing Employment %*	–0.7	5.9	1.7	1.0
Unemployment Rate %*	9.0	7.1	6.4	5.9
Real Growth in Taxable Retail Store Sales %**	7.7	10.7	7.0	5.9
Housing Unit Authorizations (000)	94.1	134.5	164.1	161.9

e = estimate

*Los Angeles, Orange, Riverside-San Bernardino, San Diego, Santa Barbara, and Ventura counties

**Adjusted for inflation with the "commodities less food" component of Los Angeles-Orange County Consumer Price Index

anticipated to be stronger than the multi-family sector. Tax reform considerations and rising vacancies are likely to slow the pace of development of multi-family units. In contrast, a further easing in mortgage rates and a preference for single-family residences stand to stimulate activity in this sector.

Declines are generally anticipated for the region's nonresidential construction over the next couple of years – particularly the office, industrial, and hotel sectors – a result of high vacancies, limited absorption of new space, and the likelihood of reduced tax incentives. A slowing trend has already begun for those sectors.

Prospects for absorption of retail projects are more encouraging than for other nonresidential categories, with space coming on line in an economy characterized by an outlook for increased consumer spending and residential building.

CENTRAL AND MOUNTAIN COUNTIES

During the first half of 1986, the Central and Mountain counties' economy generally has followed the statewide pattern. The region's labor market grew more slowly than during the last few years, but jobs continued to be created. Most of the region's industries, with the exception of the agriculture and energy sectors, have made considerable gains since the early 1980s' recession. The decline in interest rates during the first half of 1986 has spurred single-family home construction, while multi-family dwelling construction has softened in an already saturated market. Retail sales are still making gains but growth rates are slowing.

Growth prospects for the region will be limited by continued weakness in two of its basic industries – farming and petroleum.

The sharp drop in the price of petroleum has set off industry changes which have negative short- and long-term repercussions for several Central & Mountain counties. Already, many of the wells in the Central Region have been shut in (made inactive) while others will have the same fate if the price of low-grade crude remains depressed. Furthermore, oil service and supply companies in the area are suffering because of the petroleum industry's troubles.

Like the petroleum industry, the Central and Mountain Region's agricultural sector is in a slump. Persistently low commodity prices (due in part to increased production), rising production costs, and weak foreign demand for U.S. farm products have brought severe hardship to the region's growers. No dramatic improvement in this situation is expected over the next 18 months.

In contrast to farming and petroleum, lumber and wood products production, a vital industry for many of the Mountain counties, is turning around after several years of structural change. Lumber production has gone steadily upward for the past two years, and with housing construction in the state expected to remain relatively strong throughout 1986, the lumber industry should continue to make gains. Employment in the industry, although on the increase, is nowhere near the record levels reached for the region in the late 1970s and is not anticipated to match those levels at any time in the near future.

Notwithstanding the troubles affecting agriculture and petroleum, most sectors of the Central and Mountain region's economy should show moderate growth over the next 18 months due to increased retail trade activity, employment gains in service and retail businesses, and moderate increases in commercial & industrial construction. Residential construction, which was a principal impetus earlier in the recovery, will show mixed trends, with the strength likely to be concentrated in the single-family home sector.

Since early 1983, when the region was still experiencing a severe drop in its employment, the labor market of the Central and Mountain region has improved considerably. All sectors except agriculture have

Selected Economic Indicators:
33 Central and Mountain Counties of California

	1983	1984	1985	1986e
Growth in Total Wage and Salary Employment (%)*	0.7	4.7	2.9	2.5
Unemployment Rate (%)*	13.1	11.2	10.6	10.1
Real Growth in Taxable Retail Sales (%)**	10.6	5.6	1.7	1.4
Annual Housing Unit Authorizations (000)	41.0	45.1	53.3	50.1

*Based on data from El Dorado, Fresno, Kern, Placer, Sacramento, San Joaquin, Stanislaus, and Yolo counties.

**Adjusted for "commodities less food" component of California's Consumer Price Index.

increased their employee base. Unemployment rates for most of the region's counties have dropped notwithstanding labor force expansion, but double-digit jobless rates continue to prevail in most Central and Mountain counties. Several factors are responsible for the region's high unemployment rates, including the cyclical nature of employment in agriculture (one of the region's primary industries) and the negative effect in recent years of the strong U.S. dollar on the region's exports.

Over the next 18 months, the region should continue to record employment gains but at a slower rate than in recent months. Retail trade, services and construction will be the leading industries for job gains. The agricultural sector's employment outlook for 1987 will reflect 1986's pattern, with agricultural employment dropping slightly.

Growth in consumer spending slowed in the region during 1985, and early indicators for this year reflect a continuation of this trend. After the early 1980s' recession consumers went on a spending spree in 1983 and 1984. More recently, spending growth has become much less pronounced as demand for durable goods has waned and consumer debt has become a growing concern for many. Over the next 18 months, retail sales growth should be modest as slower growth of employment and personal income plus concern for personal debt curtail consumer purchases.

Home construction in the region, which experienced one of its strongest years during 1985, is showing signs of weakness this year. An oversupply of condominiums and other forms of attached housing (a phenomenon the state has been experiencing for over a year) has finally reached the region which at one time had a very limited supply of this type of housing. In contrast, lower mortgage rates during the first part of the year made single-family housing more affordable to many buyers and, as a result, single-family dwelling construction (as measured by permits issued) increased 11 percent in the first three months of 1986 compared with the same months in 1985.

Through the end of the year and in 1987, homebuilding in the area should continue its moderate decline from 1985's high level, with the single-family sector performing considerably better than multi-family dwellings. Following a statewide trend, increased demand for single-family homes has pushed home prices in the area upward during the early months of 1986, dampening some of the positive gain made by lower mortgage rates. However, the area's housing prices are still considerably lower than other regions in the state.

NORTHERN COASTAL CALIFORNIA

The first half of 1986 was a disappointing period for the Northern Coastal region's economy, although there were a few bright spots. The favorable trends were low inflation and a vigorous housing market. But overall the first half of the year did not live up to expectations, as the local economy continued to

Selected Economic Indicators: Northern Coastal California

	1983	1984	1985	1986e
Growth in Nonag Employment (%)	1.7	5.9	2.5	2.0
Growth in Manufacturing Employment (%)**	–1.8	7.4	–0.9	–1.5
Real Growth in Taxable Retail Sales (%)*	10.0	8.2	4.3	3.2
Unemployment Rate (%)**	7.8	6.0	5.8	6.0
Annual Housing Unit Authorizations (000)	33.3	38.1	46.2	45.0

e = estimate

*Adjusted for inflation with the "commodities less food" component of the San Francisco – Oakland Consumer Price Index

**Nine-County San Francisco Bay Area

languish. At midyear, the triple stimulative dose of lower interest rates, the sharp depreciation of the dollar, and the steep fall in oil prices had largely failed to stimulate the local economy. Business activity in the region – particularly the San Francisco Bay Area – was further restrained by the lackluster performance of its key manufacturing activity – high-technology.

The local economy's first half performance is, perhaps, best illustrated by the lethargy that characterized the job market. Job creation in the first half fell to its lowest rate – 2.1 percent per annum – since 1983, the first year of recovery from the 1981-82 recession. Job prospects in manufacturing were especially poor, with job losses persisting although at a diminished rate from 1985. In the San Francisco Bay Area, the strongest growth in total employment was witnessed by the East Bay while the weakest was experienced by Santa Clara County, where employment was essentially stagnant during the first half of 1986. The non-Bay Area counties of Northern Coastal California fared better than the 9-county Bay Area. During the first half of the year, employment was up 4.7 percent in Monterey County and 6.0 percent in nearby Santa Cruz County. Strong residential construction activity for the third consecutive year has provided some relief to the lumber-dependent counties of Humboldt and Mendocino. In the first half of the year, each county's unemployment rate had fallen to its lowest level – under 11 percent – since the late 1970s.

Retail sales in the Bay Area during the first half of 1986 were lackluster, particularly in Santa Clara County. The strength in the housing market did manage to stimulate sales of building materials and home furnishings and appliances. Numerous projects in the construction pipeline will keep developers of nonresidential projects busy throughout this year. However, signs of an impending slowdown appeared in the early months of 1986. All major segments of the nonresidential market experienced a slowdown during the first four months of 1986.

While prospects through 1987 are generally for a more vigorous performance than the lackluster first half, that is far from certain. The housing sector, and especially single-family residences will remain strong, due to a favorable financial environment and a shift in home buyers' preferences for single-family detached homes. Inflation will remain under wraps, despite some anticipated acceleration next year. However, major improvement in the electronics industry will be slow in coming. Orders for electronic products will be kept at bay by weakness in capital expenditures of U.S. businesses, sluggish economic growth abroad, and imports from the Far East countries of Taiwan and South Korea. Those countries, whose currencies have not risen in value against the dollar, have made inroads in the domestic computer industry. However, U.S. electronics manufacturers should find it somewhat less difficult to penetrate the Japanese and European markets, the countries whose currencies have risen appreciably against the dollar.

In other sectors, construction of nonresidential properties is vulnerable to further declines, reflecting high vacancies and tax reform jitters. Tax reform considerations and rising vacancies also are likely to slow the pace of development of multi-family units in the second half of 1986 and 1987. Consumer spending will continue to benefit from the strength in the real estate market, low interest rates, and lower energy prices but be restrained by limited gains in employment. Mergers and the restructuring in the oil industry and financial services are likely to dim job prospects in the second half of 1986 and into next year. Overall, the region's total nonfarm employment is projected to increase by about 2 percent for all of this year and slightly more in 1987, with most of the growth accounted for by homebuilding and related industries, retail trade, and services. This year's 2 percent growth in nonfarm employment compares with growth rates of 2.5 percent last year and 5.9 percent in 1984.